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Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515–6315

To: Members, Committee on Small Business
From: Committee Staff
Date: January 12, 2016
Re: Full Committee Hearing: "SBA Management Review: Oversight of SBA's Access to Capital Offices"

On Tuesday, January 12, 2016, at 10:00 a.m. in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet to examine capital access programs operated and overseen by the Small Business Administration (SBA). The United States Government Accountability Office (GAO) recently released a report about the operation of the Small Business Administration (SBA) and found numerous deficiencies in SBA management.[1] In conjunction with this report, the Committee is holding a series of hearings that will provide oversight of various SBA offices and examine ways to improve current operations of the SBA. This hearing will examine the Office of Capital Access (OCA) and Office of Credit Risk Management (OCRM). Specifically, the hearing will look at whether improvements within these Offices are necessary to ensure sufficient lender oversight and effectiveness in helping small firms obtain capital.

I. Introduction

Unlike large enterprises that can obtain funds from commercial debt and equity markets, small businesses must rely on their own personal assets, retained earnings, and commercial banks for needed capital. For more than 60 years (since the July 1953 creation of the SBA during the Eisenhower Administration), the SBA has sought to fill gaps in the commercial debt and equity markets. The four major programs overseen by the SBA relative to access to capital are the: 7(a) Guaranteed Loan Program (7(a)); Certified Development Company (CDC) Loan Program; Small Business Investment Company Program (SBIC); and the Microloan Program. This hearing will focus on SBA oversight of the 7(a) and CDC programs.[2]

II. Description of OCA and OCRM

Within SBA, the offices responsible for handling the capital access programs are the Office of Investment and Innovation (OII), OCA, and OCRM. This hearing memo will not address OII which oversees the SBIC programs, along with other non-financial programs, as that will be

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[1] GAO, SMALL BUSINESS ADMINISTRATION: LEADERSHIP ATTENTION NEEDED TO OVERCOME MANAGEMENT CHALLENGES (GAO-15-347) (2015), *available at* http://www.gao.gov/products/GAO-15-347 [hereinafter "GAO Management Report"].

[2] The Microloan program presents little or no risk to taxpayers and the SBIC program is no longer overseen by either OCA or OCRM.

addressed by the Committee in a future hearing.[3] OCA is responsible for helping to "make capital available through banks and other lending partners to small businesses,"[4] whereas OCRM is "responsible for oversight and risk management of SBA's [lending] programs."[5] Given this, OCA and OCRM must work closely to ensure that the guidance provided to both lenders and small businesses is clear and allows the use of the programs while mitigating the risk to taxpayers.

III. Description of Programs Overseen by OCA and OCRM

The SBA oversees the operation of two major lending programs in which the SBA provides guarantees through private lenders – the 7(a) and CDC programs. The programs operate on the premise that certain borrowers (with solid business prospects) are unable to obtain credit through normal commercial sources without obtaining a guarantee offered by the federal government, i.e., that they are unable to obtain credit elsewhere.

The 7(a) program provides loans through financial institutions[6] with loans of up to $5 million and guarantees ranging from 75 to 85 percent depending on the size of the loans, with larger loans having lower guarantee percentages. As a general rule, loans may be made for any valid business purpose. Borrowers pay an upfront fee and lenders pay an ongoing guarantee fee. Some lenders have the authority to issue guarantees without first submitting the loan to the SBA and are called preferred lenders (or lenders with delegated authority, i.e., they have been delegated by the SBA the authority to issue a guarantee without first obtaining SBA approval). A subset of these delegated lenders have the authority to operate as express lenders in which the financial institution may issue guarantees on loans of up to $350,000 using their own forms and documentation.

The CDC program utilizes non-profit organizations established to promote local economic development. Loans made through the CDC program are for the long-term purchase of physical assets, such as real estate or equipment.[7] CDCs offer debentures that cover 40 percent of the project cost which is guaranteed by the federal government. Other financial institutions provide 50 percent of the cost of the project (and have a so-called first lien position which gives the bank preference in any bankruptcy proceeding) and the borrower contributes 10 percent. Although there are CDCs that can approve the issuance of guarantees without SBA review, almost all CDC loans are made after the SBA has reviewed them. Borrowers, first-lien holders, and CDCs pay fees to cover the cost of the program.

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[3] As this demonstrates, the SBA's assignment of delegations for various programs can be confusing, particularly to small businesses, as all financial assistance programs are not easily identified within one office. The SBA's delegation notice for OCA and OCRM provides a specific breakdown Delegations of Authority: Delegation of Authority No. 120G, Revision 1, 79 Fed. Reg. 56,842-56,844 (Sept. 23, 2014).

[4] https://www.sba.gov/offices/headquarters/oca/about-us.

[5] OFFICE OF INSPECTOR GENERAL, SBA, SBA NEEDS TO IMPROVE ITS OVERSIGHT OF LOAN AGENTS, Exec. Sum. (2015), *available at* https://www.sba.gov/sites/default/files/oig/Report_15-16_SBA_Needs_to_Improve_Its_Oversight_of_Loan_Agents.pdf.

[6] Except for a few institutions that do not take deposits and only make loans in the 7(a) program, almost all participating lenders are regulated by either federal or state financial regulators.

[7] CDCs generally were prohibited from offering loans to refinance existing debt and refinancing had to occur through the 7(a) loan program. That changed in December 2015 with amendments by Congress, which will be discussed more fully later in this memorandum.

IV. Recent Programmatic Changes to the 7(a) Program

In FY 2015, the SBA's 7(a) loan volume hit an all-time high of roughly $23.5 billion.[8] While this demonstrates the need and importance of this program, such historic high levels of lending must be carefully assessed to ensure that loans actually are being made to borrowers who have worthy businesses but are unable to obtain credit through normal commercial sources. During the past two fiscal years, Congress has had to raise the 7(a) lending authority at the last minute to ensure small businesses could continue to utilize this program. Most recently, for FY 2015, Congress authorized $18.75 billion in 7(a) lending authority. However, given the demand on the program the SBA reached its authorized limit on July 23, 2015, and was unable to provide loans. Congress quickly acted and the President signed the *Veterans Entrepreneurship Act of 2015* which raised the SBA's 7(a) lending authority to $23.5 billion for the reminder of FY 2015 on July 28, 2015.[9] For FY 2016, the SBA has received $26.5 billion.[10] However, in doing so, Congress is requiring the SBA to provide a report by April 1, 2016, which provides a "plan for future instances where loan demand may exceed program authority."[11]

Additionally, as noted above, in order to be eligible for the 7(a) program, the borrower must be unable to obtain credit elsewhere.[12] The SBA's test for credit elsewhere is found in regulations and further clarified within a standard operation procedure (SOP).[13] The SBA requires the lender to document the bank's determination that the borrower could not obtain credit elsewhere; some of those factors in the SOP include, but are not limited to, the collateral does not meet the lender's policy requirements or the business needs a longer maturity than the lender's policy permits.[14] However, concerns regarding some of the factors listed in the SOP led to the recently passed *Veterans Entrepreneurship Act of 2015* statutorily altering the credit elsewhere test found in the existing SOP.[15] This eliminated the ability of the lenders to utilize as the sole basis of "no credit elsewhere" the bank's own liquidity,[16] rather than the borrower's ability to access commercial credit. Although the SBA has not updated the SOP to reflect the statutory changes, it sent a procedural notice to its employees requiring them to notify lenders of the change.[17]

[8] https://www.sba.gov/sites/default/files/aboutsbaarticle/WebsiteReport_asof_09_30_2015.pdf.

[9] Veterans Entrepreneurship Act, Pub. L. No. 114-38, 129 Stat. 437, 438.

[10] The lending authority cap was incorporated into of the Consolidated Appropriations Act, 2016 Act, Pub. L. No. 114-113. Specifically, this can be found as part of Division E, Title V.

[11] 161 Cong. Rec. H9694, H10,140 (daily ed. Dec. 17, 2015) (explanatory statement submitted by Mr. Rogers of Kentucky, Chairman of the House Committee on Appropriations, Regarding House Amendment No. 1 to the Senate Amendment on H.R. 2029).

[12] 15 U.S.C. § 636(a)(1)(A)(i).

[13] 13 C.F.R. § 120.101 and SOP 50 10 5(H), Subpart B., Ch. 2(III)(C)(3)-(5) [last updated May 2015].

[14] SOP 50 10 5(H), Subpart B., Ch. 2(III)(C)(4).

[15] 15 U.S.C. § 636(a)(1)(A)(i)-(ii).

[16] *Id.* at § 636(a)(1)(A)(ii).

[17] Please note a statutory change supersedes the SOP language making it null and void. However, it is unclear why the SBA failed to update the SOP given the fact that SOPs are not issued pursuant to the notice and comment requirements of the Administrative Procedure Act (APA) and it would have been easy to update the SOP. *See* SBA INFORMATIONAL NOTICE, THE VETERAN'S ENTREPRENEURSHIP ACT OF 2015: FEE RELIEF FOR VETERANS AND CREDIT ELSEWHERE, Control No. 5000-1356 (on file with Committee). For a complete discussion of the legal nature of SOPs and how the SBA abuses their use in violation of the APA and its own rules, see Letter from the Hon. Steve Chabot, Chairman, Committee on Small Business, to Ms. Mary Frias, Office of Capital Access, SBA at 39-44, 50-53 (Mar. 27, 2015) (on file with the Committee) (hereinafter "Franchise Letter").

V. Recent Programmatic Changes to the CDC Program

Historically, CDC loans could not be used for purposes of refinancing existing debt.[18] The rationale behind the prohibition was that refinancing, while potentially beneficial to the business to reduce debt, was not a key component of economic development that led Congress to create the CDC program. The Small Business Jobs Act of 2010 created a two-year temporary authorization to permit CDCs (using the same basic lending structure outlined above) to refinance existing non-governmental debt, i.e., debt not issued by the SBA or any other federal agency. Unlike a normal CDC loan which requires that the loan create or save jobs, the CDC refinancing program authorized the SBA to impose, but did not require, job savings or retention requirements; the SBA opted not to impose any when it implemented the program. In December 2015, the refinancing program was made permanent with one key change as the refinancing is now contingent upon both job creation and job retention as found within a traditional CDC loan.[19]

VI. Management Challenges and Issues for Consideration

As previously discussed at a prior hearing, the GAO found several management challenges at the SBA.[20] When broken down by each Office, these challenges present unique obstacles for OCA and OCRM.

The recent programmatic changes within the 7(a) and CDC programs show continued growth in the Agency loan portfolio. In order to protect the taxpayer, it is imperative that the SBA address two long-standing management challenges related to lender oversight and loan guarantee purchases which are more specific to OCA and OCRM's missions.[21] For example, as previously mentioned within this memorandum, in order to be eligible for the 7(a) program the borrower must be unable to obtain credit elsewhere.[22] Enforcement of this statutory standard perforce mandates the SBA perform sufficient oversight rather than simply relying on the assertion of the lender. One issue likely to arise at the hearing then is whether the SBA has sufficient capability to provide adequate lender oversight to ensure its lenders comply with statutory requirements. Similarly, the recent changes to the CDC program raise a question about the Agency's ability to ensure that CDCs continue their primary mission of promoting local economic development.

Clearly, lender oversight and operation of the capital access programs fall squarely within the authority of OCA and OCRM.[23] However, there are other challenges that must be overcome to ensure the efficient and effective operation of OCA and OCRM. These include, but are not limited to, undocumented decision making, ensuring adequate information technology, and a skilled workforce.

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[18] For businesses seeking to refinance existing debt, they would have to utilize the 7(a) loan program.

[19] The change was incorporated into of the Consolidated Appropriations Act, 2016 Act, Pub. L. No. 114-113. Specifically, this can be found as part of Division E, Title V.

[20] For further information please review the GAO Management Report, *supra* note 1, as well as the Committee's memorandum on *Attention Needed: Mismanagement at the SBA* (Jan. 2016), *available at* http://smbiz.house.gov/uploadedfiles/1-06-2016_memo.pdf.

[21] GAO Management Report, *supra* note 1, at 20.

[22] 15 U.S.C. § 636(a)(1)(A)(i)-(ii).

[23] This assumption is based on the available delegations of authority from the SBA which are themselves problematic according to GAO and the Committee.

a. Undocumented Decision Making and the Use of Procedural Notices

As previously noted in this document the Agency utilizes procedural notices[24] by which it notifies *its employees* of decisions and then expects employees to notify the affected public about such decision. First, it is unclear whether the affected public ever actually receives actual notice of what is contained in these so-called procedural notices.[25] Second, use of procedural notices enables the SBA to issue and rescind policy declarations, making it difficult for the regulated community to adjust their behavior to these new policy directives.

The use of these procedural notices is evidenced by the Agency's recent difficulties in interpreting the Anti-Deficiency Act (which prohibits federal employees from entering into obligations prior to the enactment of appropriations unless permitted by some other law).[26] For decades, the SBA found no problems in closing CDC loans with open-ended indemnity agreements.[27] Then in late 2013, an OGC attorney in a district office reviewing a loan from a CDC in Hawaii determined that an open-ended indemnity agreement violated the Anti-Deficiency Act (with no written decision or any other issuance from the Agency that suggested the previous policy would be reversed). It is unclear whether other OGC district counsel interpreted the Anti-Deficiency Act in the same way. The response of the SBA "officially" arrived in terms of a procedural notice in September of 2014 that imposed obligations on CDCs to obtain waivers of open-ended indemnity agreements.[28] Seven months later, the Agency rescinded that procedural notice thereby returning the SBA to its longstanding interpretation of the Small Business Investment Act of 1958 and the Anti-Deficiency Act. Nothing prohibited the SBA from changing its interpretation; the problem was that the Agency violated the Supreme Court dictates that an agency must explain its changes in policies[29] – something that did not happen in the case of the Anti-Deficiency Act and CDC debentures. As this issue relates directly to programs overseen by OCA and OCRM, the hearing will discuss the use of procedural notices and how these offices plan to properly notify the regulated community so that lender oversight can move forward.

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[24] For a detailed discussion of SBA procedural notices, see Franchise Letter, *supra* note 17, at 18-19.

[25] *Id*. at 19 n.70, 54. Procedural notices or their availability are not published in the Federal Register or easily uncovered on the SBA website. As a test of procedural notice awareness, Committee staff conducted an informal survey in May 2015 of CDCs to determine whether they were aware of any procedural notices. The admittedly unscientific survey revealed that only about half of the companies knew of the procedural notices.

[26] 31 U.S.C. § 1341(a)(1)(B).

[27] The Anti-Deficiency Act, in its current form, was enacted in 1950 – three years before the SBA was created. In some cases, the real property that is purchased by a borrower using a CDC debenture may contain an agreement by which the borrower agrees to indemnify adjacent landowners against damages that the borrower's activity may cause to these adjacent landowners. These indemnification agreements may have limits in terms of years or dollar value of damages; in other instances the agreements may be open-ended without limitations on when the borrower would be liable or the amounts of such liability has no dollar limit. If the borrower defaults on the CDC loan and the SBA seizes the property, the SBA then potentially becomes liable under the indemnity clause. To the extent that such indemnity clauses are open-ended they may run afoul of the Anti-Deficiency Act; however, there is no legal opinion from GAO or a court that specifically addresses such indemnity agreements in the context of guaranteed loans whose costs are accounted for in a given year under the Federal Credit Reform Act.

[28] It is unclear whether all CDCs received actual notice of the contents of the procedural notice. Further, it is unclear how the SBA can impose obligations related to the Act on private parties since the strictures of that Act only apply to federal employees and violations of such may impose criminal penalties only on federal employees. 31 U.S.C. § 1350.

[29] *E.g., Smiley v.Citibank (South Dakota), N.A.*, 517 U.S. 735, 742 (1996); *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 29-50 (1983); *ConocoPhillips Co. v. EPA*, 612 F.3d 822, 833 (5th Cir. 2010).

b. Information Technology Acquisition

SBA relies heavily on information technology in the management of its capital access programs; from back office operations utilizing its Loan Management Accounting System to interfacing with the public and lenders through SBA One. The Office of Management and Budget issued guidance to federal agencies on the best practices to manage acquisition of information technology. GAO's assessment of SBA's compliance with this guidance shows mixed results. Some of the information technology projects undertaken by SBA went through a detailed review process known as TechStat.[30] On the other hand, the Agency abandoned TechStat reviews for other information technology projects and determined that other oversight in the Agency would be an adequate substitute for TechStat.[31] Of course, those determinations were made by a Chief Information Officer no longer at the SBA so it is unclear whether the oversight for information technology acquisition remains adequate. This is particularly troubling in that SBA employs different computer systems to process 7(a) and CDC loans in its Sacramento Loan Processing Centers.

c. Human Capital Planning

The SBA admits that it faces significant challenges in staffing the Agency with an adequate workforce: employees lack necessary skills as the SBA evolves; an aging workforce with more than half eligible to retire by 2019; and lack of funds to retain individuals with needed skills.[32] In response, the SBA has begun to develop a workforce plan.[33] However, the workforce plan does not incorporate key principles developed by GAO for creating an adequate agency workforce plan.[34] It is unclear whether that workforce plan will include OCRM and assess the skills needed by OCRM employees to perform adequate lender oversight.

VII. Conclusion

The SBA offers a number of programs which aim to fill gaps in the lending market and increase small firms access to capital by partnering with financial institutions and private investment funds. Given that access to capital remains a key issue for small firms, the OCA and OCRM must be managed properly. The issue of how to enhance lender oversight for example, becomes muddied when other issues such as undocumented decision making, inadequate acquisition management, and human capital planning serve as roadblocks. Given this, the Committee will hear from OCA and OCRM how it plans to tackle these various management challenges in a meaningful way to achieve their various missions.

[30] GAO Management Report, *supra* note 1, at 81.
[31] *Id*. at 81-82.
[32] *Id*. at 44-45. The findings by GAO are bolstered by SBA communications with the Committee about its inability to fund sufficient salaries for procurement center representatives. Of course, the SBA has typically requested significant sums for additional educational outreach and very little in funds for procurement center representatives from Congress.
[33] *Id*. at 46-47.
[34] *Id*. at 47.